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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 839

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

The Smoot Sand & Gravel Corporation, by its counsel, prays that a writ of certiorari issue to review the judgment entered in this case[1] by the United States Court of Appeals for the Fourth Circuit.

[1] 15 TCM 418 (1956), reversed and remanded 241 F. 2d. 197, 50 AFTR 1612 (1957), footnote 4 deleted from Court of Appeals' opinion and rehearing denied (1957), certiorari denied 354 U.S. 922, 1 L. Ed. 2d. 1437 (1957), retried and decided 17 TCM 1086 (1958), affirmed 274 F. 2d 495, 5 AFTR 2d. 626 (1960), rehearing denied (February 24, 1960).

FINDINGS OF FACT AND OPINIONS BELOW

The Report of the Tax Court Commissioner (1955) and the first (1956) and second (1958) memorandum findings of fact and opinions of the Tax Court are not officially reported but are printed in the certified transcript of record (Vol. I, 1a-73a).[2] The first and second opinions of the Court of Appeals are reported at 241 F. 2d 197, 50 AFTR 1612 (1957) and 274 F. 2d 495, 5 AFTR 2d 626 (1960). Both opinions of the Court of Appeals, including the subsequently deleted footnote 4 contained in the first opinion, are printed in the Appendix, *infra*, pp. 1a-39a.

Respondent opposed certiorari with respect to the Court of Appeals' first opinion on the ground that "At this stage of the proceeding, it has not yet been determined whether taxpayer is liable for Section 102 tax for the years in controversy" and, therefore, "There are no unusual circumstances calling for" the Supreme Court's "intervention prior to determination of the ultimate factual question by the courts below." Certiorari was denied and the case was returned to the Tax Court for further trial pursuant to mandate of the Court of Appeals.

JURISDICTION

The judgment of the Court of Appeals was entered in January 11, 1960 (App., *infra*, 40a). Petition for rehearing was filed on February 8, 1960 and was denied

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[2] Abbreviations used herein are as follows:

Vol. I, II, III—The certified transcript of record is in three volumes and will be referred to by the respective volume and page numbers.

R—Refers to record page before the Court of Appeals.

App., *infra*—Refers to the Appendix printed herein.

Stip.—Stipulated facts agreed upon by the parties.

by order of the Court of Appeals on February 24, 1960 (App., *infra*, 41a). The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTIONS PRESENTED

1. Whether replacement of exhausted facilities and mineral deposits constitutes a reasonable business need to be taken into consideration under the penalty surtax provisions of Section 102 of the Internal Revenue Code of 1939, or whether, as held below, such replacement requirements cannot be taken into consideration in determining reasonable business needs?

2. Whether the Court of Appeals, in direct conflict with decisions of this Court, erred in holding that petitioner was not entitled to accumulate any earnings to replace admittedly exhausted assets at any price, i.e., at either (a) the inflated cost prevailing during 1945-1950 or (b) the low prewar original cost reflected in petitioner's depreciation and depletion reserve accounts?

3. Whether the correct test, as held by the Second Circuit, for determining petitioner's need to accumulate earnings as a protective measure against imminent destruction of the business because of changed conditions should be based upon the honest belief of its officers during 1945-1950 rather than, as held below, upon what may now, on the basis of hindsight, appear to others to have been reasonable?

4. Whether the Court of Appeals, in direct conflict with decisions of this Court and other Courts of Appeals, erred in ignoring (a) the findings of the Tax Court Commissioner and the Tax Court and (b) the

documentary proof and testimony of ten eminently qualified witnesses, when throughout two lengthy trials respondent produced no witness to testify that petitioner accumulated earnings beyond the reasonable needs of its business?

5. Whether, although petitioner was clearly deprived of the statutory right to have its case (a) considered on the merits by the Secretary of the Treasury or his delegate and (b) tried and decided by the Tax Court with the burden of proof on respondent, the Court of Appeals erred, in violation of the August 11, 1955 amendment to Section 534 of the Internal Revenue Code of 1954, in "assuming" that such important substantive and procedural rights would have been of no avail to petitioner?

STATUTES, REGULATIONS AND SENATE FINANCE COMMITTEE REPORT INVOLVED

These are printed in the Appendix, *infra*, pp. 42a-48a.

STATEMENT

The ultimate issue is whether petitioner unreasonably accumulated earnings beyond the needs of its business in the years 1945 through 1950 and is, therefore, subject to Section 102 penalty surtax for those years.

This case was first tried before the Tax Court in 1954 and retried on the merits in 1958, pursuant to reversal and remand of the Court of Appeals.

To avoid confusion, it is pointed out that the findings of fact by the Tax Court Commissioner, which were adopted by the Tax Court as its findings, strongly support petitioner's position (Vol. I, 1a-40a). Therefore, petitioner relies upon the facts as found below

despite adverse decisions inconsistent and conflicting with the found facts. For example:

(1) The Tax Court found that petitioner's stipulated losses sustained through depreciation, depletion and bad debts were from $2,175,170.39 to $2,566,481.31, but, without any explanation for so doing, the Court overlooked those replacement needs in its opinion (Vol. I, 19-29). The Court of Appeals sought to justify this oversight on its newly stated theory that replacement of exhausted operating facilities, depleted mineral deposits, and bad debt losses cannot be taken into account in determining reasonable business needs (Vol. III, Petition for rehearing, pp. 1-7).

(2) The Tax Court found that petitioner's Federal income tax liabilities, not listed on its balance sheet, ranged up to $1,794,562.00, but without explanation failed to take into account any part of such liabilities in determining reasonable business needs (Vol. I, 19-29, 12a, 31a; Vol. III, Petition for rehearing, pp. 14-15). The Court of Appeals sought to justify this error on the basis of its mistaken belief that the $1,794,562.00 included income tax liabilities of other taxpayers (Vol. III, Petition for rehearing, pp. 14-15).

Petitioner began business in 1927 with assets of more than $7,365,179.85 (Vol. I, 1a, 19a; Stip. Ex. 14; R. 927-928). In 1927 petitioner's production facilities were in excellent operating condition and its supply of sand and gravel in up-river deposits close to distribution centers was ample (Vol. I, 24a, 25a, 27a; R. 240-241).

In 1945-1950 petitioner's up-river deposits were exhausted and its operating facilities were worn out (Vol. I, 24a, 25a, 27a). Petitioner's total assets com-

pared with its recorded liabilities and reserves, found below, as follows (Stip. Ex. 14; Vol. I, 12a, 14a, 17a, 31a, 34a, 39a-40a):

Year	Total Assets	Liabilities and Reserves	Deficits
1945	$7,003,917.83	$7,813,657.96	($ 809.740.13)
1946	7,240,879.10	8,365,270.33	(1.124.391.23)
1947	7,624,693.11	9,149,541.93	(1.524.848.82)
1948	7,858,778.29	9,516,556.31	(1.657.778.02)
1949	7,880,412.59	8,183,781.86	(303.369.27)
1950	8,271,879.53	8,435,649.78	(163.770.25)

The above deficits do not take into account petitioner's financial requirements for working capital or to restore its gravel inventory which became exhausted in 1944. Also, such deficits, as shown by the Tax Court's findings, are based on the assumption that in 1945-1950 petitioner could replace its exhausted operating facilities and depleted deposits at original low prewar cost and would not be required to pay the inflated cost prevailing in 1945-1950.

Petitioner's depreciation and depletion reserves, based upon original cost, ranged from $2,041,378.29 to $2,358,419.03 during 1945-1950 (Vol. I, 39a-40a). Admittedly, as found by the Tax Court, the 1945-1950 cost to cover depreciation and replacement of needed facilities was from $4,366,489.38 to $6,700,733.16 (Vol. I, 33a-34a)—not taking into account replacement of depleted deposits.

The Court of Appeals' first opinion held that the $4,366,489.38 to $6,700,733.16 for replacement of depreciable facilities could not be taken into consideration as a reasonable business need because those were the amounts required to replace at the inflated prices prevailing during 1945-1950 (App., *infra*, 7a-8a).

Petitioner feels that this holding is clearly erroneous and it was the principal ground upon which certiorari was requested with respect to the first opinion.

Failure to take into account the sky-rocketing inflation of the 1945-1950 period seems particularly unsound in view of the fact that as a result of inflation petitioner was far worse off economically—to the extent of nearly $2,000,000.00—at the end of 1950 than at the beginning of 1945, despite the fact that its earnings, less taxes paid, had been retained in the business and substantially expended for tugs, barges and other essential requirements. However, respondent opposed certiorari on the ground that there had then been no final determination as to petitioner's liability for Section 102 penalty surtax and certiorari was denied.

The second opinion of the Court of Appeals has now finally held that petitioner was not entitled to accumulate any earnings whatsoever to replace its admittedly exhausted assets at either the low prewar original cost or at the prices prevailing during 1945-1950 and, for that reason, has imposed penalty surtax (App., *infra*, 31a-33a).

When liquid assets only are taken into account, the reasonable business needs, as found by the Tax Court, including the necessity for replacing exhausted property, show that the 1945-1950 *deficits* in liquid assets *on the Tax Court's own basis*, ranged from $5,195,805.09 to $7,889,952.15 (Vol. III, Petition for Rehearing, pp. 15-18).

When total assets are taken into account and compared with total reasonable needs established by documentary proof and undisputed testimony of ten

eminently qualified witnesses, it is clear that the 1945-1950 *deficits* ranged from $11,276,341.66 to $17,207,940.39 (Vol. I, 8-11, 19-26).

Petitioner's 1945-1950 retained earnings not expended in the carrying on of its business lacked from $1,747,797.93 to $3,088,915.71 of being enough to pay its 1945-1950 indebtedness (Vol. II, 9-10). Petitioner's total retained earnings, *during its entire existence,* not expended in carrying on its business lacked from $280,425.59 to $1,529,175.03 of being enough to pay its liabilities in 1945-1950 (Vol. II, 9-10).

Petitioner emerged from World War II in a seriously weakened condition. In 1945-1950 it suffered an annual average decrease of over 700,000 cubic yards in production of sand and gravel (Vol. I, 25a). This, as found by the Tax Court, was because at "the close of World War II much of petitioner's production equipment was in a run down condition and badly in need of replacement" and because "the best of" petitioner's up-river "deposits, particularly the gravel deposits had been exhausted" (Vol. I, 25a, 27a). Also, as found by the Tax Court, petitioner's inventory of gravel had become exhausted in 1944 (Vol. I, 5a, 24a). The Tax Court found that because of its weakened condition, "In some instances customers' requirements had to be cut in half" during 1945-1950 (Vol. I, 27a-28a).

The threat of the ready-mixed concrete industry to petitioner's business in 1945-1950 was correctly found by the Tax Court Commissioner and the Tax Court as follows (Vol. I, 9a-10a, 28a-29a):

> "For a number of years the ready-mix concrete business has been developing rapidly both on a

national scale and in the Washington, D. C. area. It was firmly established by about 1940 and at the present time it constitutes the larger portion of the concrete business.

"* * * In the beginning the ready-mix business was operated independently of the sand and gravel business, such as petitioner's. However, many of the sand and gravel producers have themselves gone into the ready-mix business *in order to protect their market.* Also, many of the ready-mix concerns have gone into the sand and gravel business to obtain their supplies of material. The general trend has been toward a merger of the two branches of the industry.

"In the Washington, D. C. area, as well as in most other large construction areas, the ready-mix industry has become the dominant factor in the concrete market. Several of the large ready-mix concerns in the Washington, D. C. area have purchased some or all of their sand and gravel from the petitioner. As their business expanded, petitioner was unable to supply their demands for sand and gravel and they were forced to look to other sources. In the meantime, the ready-mix concerns began demanding certain price concessions and other concessions which petitioner was unable or unwilling to grant, and transferring as much of their business as possible to petitioner's competitors. *By 1945 this situation had reached the point where, in the opinion of petitioner's officers, it constituted a severe threat to petitioner's business. Petitioner was confronted with the alternative of going into the ready-mix business itself or losing the major portion of its sand and gravel market.* Petitioner had always favored the development of the ready-mix business as a separate industry from the sand and gravel business and had given substantial financial assistance to several of its ready-mix customers.

> "At one time when the strained relationship between petitioner and the ready-mix concerns approached a climax, petitioner made an estimate of the additional facilities and equipment that it would need to go into the ready-mix business itself, and engaged a 'stand-by' salesman to handle the order. A break with the ready-mix concerns was averted, however, and at the present time they are purchasing from 50 to 80 per cent of petitioner's production of sand and gravel." (Emphasis supplied)

Petitioner's market outlet for sand and gravel was controlled by the ready-mixed concrete industry in 1945-1950. Banks threatened to cut off customers' credit to force them to stop buying sand and gravel from petitioner, instigators seeking to take petitioner's business attempted to have Mr. Smoot indicted and petitioner dissolved under the anti-trust laws, and the ablest men in the industry testified that without protective funds to enter the ready-mixed concrete industry petitioner's market outlet would be cut off (Vol. I, 11a, 30a, 91a-98a; Vol. III, Petition for Rehearing, pp. 9-12). In the opinion of petitioner's officers, "During" the "1945 through 1950 period, the imminence of that threat was so great that we felt that the probability or the likelihood of The Smoot Sand & Gravel Corporation having to go into the ready-mixed concrete business was by far greater than the possibility that it might be able to stay out of it" (Vol. I, 75a-76a).

Undisputed testimony of independent experts shows that petitioner would have required from $7,286,743.10 in 1945 to $11,794,811.43 in 1950 to enter the ready-mixed concrete business (Vol. I, 92a-100a; Exs. 15, 16).

The Court of Appeals recognized that petitioner's "officers sincerely believed that it would be forced into the ready-mixed concrete industry" during 1945-1950 (App., *infra*, 25a). However, the Court of Appeals decided the issue against petitioner on the ground that the threat was avoided. The Court explained its position, on the basis of hindsight, as follows (App., *infra*, 27a):

> "It is undisputed that the corporation did not, voluntarily or involuntarily, enter" the ready-mixed concrete "business at any time."

The Court of Appeals seemingly does not doubt that petitioner's officers sincerely believed that it would be forced to enter the ready-mixed concrete business in 1945-1950. But, inasmuch as the threat has thus far been avoided, the Court of Appeals has held that it cannot be taken into account in determining petitioner's reasonable needs during 1945-1950.

Respondent made no investigation to determine whether petitioner had accumulated earnings beyond the reasonable needs of its business prior to sending the deficiency notices in this case and such notices were sent without even being read by any official authorized to determine deficiencies (R. 412-453, 787-831, 1129-1151).

Throughout two lengthy trials respondent has called no witness to testify that petitioner had accumulated earnings beyond the reasonable needs of its business during 1945-1950 or at any other time.

After an exhaustive investigation of petitioner's needs, the President of The American Appraisal Company testified that petitioner should not have paid

dividends during 1945-1950 because it "needed so badly" to replace its exhausted operating assets (R. 670). On the basis of documentary proof and testimony of ten outstandingly able witnesses the undisputed evidence shows that petitioner's reasonable needs during 1945-1950 ranged from $18,280,259.49 to $25,291,480.04 (Vol. I, 8-11).

REASONS FOR GRANTING THE WRIT

1. The Court of Appeals' Holding That Necessity for Replacing Exhausted Operating Facilities and Depleted Mineral Deposits Cannot be Taken Into Account in Determining Reasonable Business Needs Is Based Upon a Newly Enunciated Rule of Law to the Effect That Consideration of Such Admitted Replacement Needs Would Constitute Giving Taxpayers the Benefit of Unallowable "Double Deductions". This New Principle Was Not Mentioned in the Instant Litigation Until the Second Appeal and Has Never Heretofore Been Advanced in Any Other Case. The Principle Is Obviously Unsound and Is in Direct Conflict With the Decisions of This Court and All Other Authorities.

The Court of Appeals' first opinion held that petitioner was not entitled to retain earnings for the purpose of replacing exhausted assets at the inflated prices prevailing during the 1945-1950 period (App., *infra*, 7a-8a). Its second opinion now holds that petitioner is not entitled to recover from earnings the original low prewar cost for replacing exhausted assets on the ground that to take into consideration the necessity of replacement would constitute giving "the taxpayer double deductions" (App., *infra*, 31a-33a). Thus, petitioner is allowed nothing to replace exhausted assets under the newly enunciated "double deduction" theory.

In *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 291, 82 L. Ed. 1346, 1354, this Court expressly held

that in penalty surtax cases "Depreciation in any of the assets" must be taken into account "in determining the issue of fact whether the accumulation of profits was in excess of the reasonable needs of the business."

In *Knoxville* v. *Knoxville Water Co.*, 212 U.S. 1, 13, 53 L. Ed. 371, 380, this Court stated:

> "* * * Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life. The company is not bound to see its property gradually waste, without making provision out of earnings for its replacement. It is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning. It is not only the right of the company to make such a provision, but it is its duty to its bond and stockholders, and, in the case of a public service corporation at least, its plain duty to the public. If a different course were pursued the only method of providing for replacement of property which has ceased to be useful would be the investment of new capital and the issue of new bonds or stocks."

In penalty surtax cases it has always been held that "reasonable accumulations" for "maintenance and replacements" are "recognized as factors excusing the corporation from the payment of dividends." Mertens, *Law of Federal Income Taxation*, Section 39.46. Prentice-Hall collates the authorities and correctly states that "in the case of a business corporation actually engaged in commercial operation, depreciа-

tion in any of the assets is evidence in determining whether an accumulation is in excess of the reasonable needs of the business" and points out that "sound business policy may require withholding from distribution liquid assets equal to the reserve for depreciation and for obsolescence." 1960 Prentice-Hall Federal Tax Service, page 4718. See also *United States* v. *Ludey*, 274 U.S. 295, 301, 71 L. Ed. 1054, 1058; *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 101, 87 L. Ed. 1286, 1289; and *Virginian Hotel Corporation of Lynchburg* v. *Helvering*, 319 U.S. 523, 528, 87 L. Ed. 1561, 1565.

In direct conflict with the decisions of this Court and all other authorities, on the decisive issue as to petitioner's right to replace its exhausted assets, the Court of Appeals has held that such replacement requirements cannot be taken into account in determining the reasonable needs of its business. Because the erroneous "double deduction" theory was never mentioned, in this or any other case, before the second appeal, petitioner had no opportunity to demonstrate its fallacy through the testimony of expert witnesses. Consequently, petitioner relied upon the affidavit of a Certified Public Accountant explaining why the taking into consideration of its replacement reserve accounts in determining reasonable needs does not constitute giving petitioner the benefit of any deduction or of "double deductions". See Vol. III, Petition for Rehearing, pp. 26-28. Such affidavit states, in part, as follows:

> "* * * In my opinion, the taking into consideration of the losses recorded by such reserve accounts would neither constitute 'double deductions' nor any deductions at all.

"Such reserve accounts record the corporation's losses of from $2,175,170.39 to $2,566,481.31 sustained through depreciation, depletion and bad debts. To the extent that the corporation has deducted such losses from gross income and retained equivalent funds, such funds are included in its total assets. The taking into consideration of the depreciation, depletion and bad debt reserves, recording the losses, to determine the amount needed, at original cost, to replace the assets so lost does not constitute any deduction from an accounting standpoint. On the contrary, such reserve accounts recording the losses merely show the reason why the corporation was allowed to deduct such losses from gross income and the purpose for which gross income equal to the losses deducted was retained. The reserve accounts only state the amount that must be utilized from the corporation's assets if its properties lost through depreciation, depletion and bad debts are to be replaced at the original cost of such lost properties. In other words, the corporation's depreciation, depletion and bad debt reserve accounts state on the face of the balance sheets the amount of assets required at the end of each year to replace, at original cost, the corporation's assets lost through depreciation, depletion and bad debts and, therefore, the consideration of the reserve accounts recording such losses does not involve deductions from an accounting standpoint."

The Court of Appeals has *included* as a part of petitioner's financial resources the amounts retained to replace its exhausted assets and, at the same time, has held that petitioner is not entitled to show the *very purpose* for which such retention was made. Under this Court's decisions, petitioner is clearly entitled to have its total assets, as found below, com-

pared with its total liabilities and reserves, as found below, in determining the reasonable needs of its business. The Court of Appeals disregarded all authorities, including this Court's opinions, and erred in refusing to make such a comparison. See Vol. III, Petition for Rehearing, pp. 1-7.

The consequences of the newly stated "double deduction" theory are serious and far reaching. The theory cumulatively *decreases* the amount taken into account for reasonable business needs to the extent that the need for replacement cumulatively *increases* each year. Under this erroneous principle, every corporation utilizing expensive facilities or mineral deposits will be subjected to penalty surtax, if it accumulates earnings to replace its wasting assets.[3]

Elimination of depreciation and depletion reserves from consideration in determining reasonable business needs will place taxpayers, as it does this petitioner, in a vicious circle. Each year those replacement reserves increase as petitioner's operating assets decrease through exhaustion. Under the Court of

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[3] The term "surplus" is an antiquated misnomer no longer used in modern accounting. "Its use in a balance sheet without a qualifying adjective is obsolescent." *A Dictionary for Accountants*, by Kohler (1953). This is because the unearmarked surplus reflects amounts retained for business needs. To illustrate, the General Motors Corporation's balance sheet shows depreciable assets, "Less accumulated depreciation and obsolescence" of $3,257,861,754.00, in stating its total assets of $7,271,136,285.00. General Motors designates its "surplus" of $4,057,240,838.00 as being "retained for use in the business (earned surplus)." Petitioner's recorded need for replacement, as shown by its reserve accounts of $2,041,378.29 to $2,372,846.99, should be allowed in determining reasonable needs just as General Motors' replacement reserves of $3,257,861,754.00 would have to be taken into account in determining that corporation's reasonable needs.

Appeals' holding, petitioner is each year increasingly and progressively deprived of its right to provide for replacement to the extent of the cumulatively increased amount of its loss through depreciation and depletion. Such a principle is unsound and is in direct conflict with the decisions of this Court and all other authorities.

The practical effect of the newly stated "double deduction" theory places corporations in a hopeless position for this reason: The amount of liquid assets retained to replace operating assets lost through depreciation and depletion during their useful lives necessarily increases each year, otherwise, the operating assets could not be replaced when fully exhausted. Under the Court of Appeals' newly stated principle, the purpose for which these liquid assets are retained cannot be considered a need of the business because, allegedly, this would constitute giving the taxpayer the benefit of unallowable "double deductions" (App., *infra*, 31a-33a). Thus, without being allowed to show the replacement purposes for which the liquid assets were retained, the corporation will necessarily be treated as having accumulated beyond its reasonable needs if needs other than replacement are provided for. Consequently, the imposition of the penalty surtax is no longer dependent upon reasonable business needs but, with the need for replacement of lost assets excluded, will necessarily be imposed upon amounts retained beyond only a part of business needs. Not only does the newly stated theory take into account only a part of business needs, but the theory actually *treats the amounts retained to replace lost assets as being available for those other partial business needs and thereby subjects amounts retained*

for replacement to penalty surtax. Thus, the effect of the erroneous newly stated principle is to subject to the penalty surtax amounts retained to offset and replace lost assets. The Supreme Court has flatly held that a corporation cannot be placed in any such untenable position. *Helvering* v. *National Grocery Co., supra,* and *Knoxville* v. *Knoxville Water Company, supra.*

The erroneous "double deduction" theory, prohibiting consideration of depreciation and depletion losses in determining reasonable business needs, can only lead to confusion throughout the country until corrected by this Court or the Congress. Petitioner respectfully asks that certiorari be granted in order that the seriously unsound principle may be corrected in the instant case.

2. In Conflict With the Second Circuit and All Other Authorities, the Court Below Has Held That Even Though Petitioner Honestly and Sincerely Believed That the Existence of Its Business Was Under Imminent Threat by the Ready-Mixed Concrete Industry in 1945-1950, Petitioner Was Not Entitled to Take Protective Measures Because, on the Basis of Hindsight, It Is Now Known That the Threat Was Avoided.

Circuit Judge Hand in *Casey* v. *Commissioner,* 276 F. 2d 26, 3 AFTR 2d 1440 (CA 2, 1959), has succinctly and correctly stated the principle applicable, as follows:

> "* * * I believe that the statute meant to set up as a test of 'reasonable needs,' only the corporation's honest belief that the existing accumulation was no greater than was reasonably necessary."

There can be no doubt that petitioner honestly and sincerely believed in 1945-1950 that the existence of its business was imminently threatened by the ready-mixed concrete industry (Vol. I, 9a-10a, 28a-29a, 75a-79a, 87a-88a, 91a-98a, 101a-103a, 107a-109a, 114a-118a; Vol. III, Petition for Rehearing, pp. 8-13). This threat was found by the Tax Court Commissioner and the Tax Court to be as follows (Vol. I, 9a-10a, 28a-29a):

> **"* * * By 1945 this situation had reached the point where, in the opinion of petitioner's officers, it constituted a severe threat to petitioner's business. Petitioner was confronted with the alternative of going into the ready-mix business itself or losing the major portion of its sand and gravel market."**

Nevertheless, the Court below has substituted its hindsight "reasonably believed" test for the correct current "honest belief" test and held that petitioner was not entitled to take protective measures against the imminent threat as found by the Tax Court. The Court, on the basis of many years' hindsight, has held that its "reasonably believed" test is not met because now "It is undisputed that the corporation did not, voluntarily or involuntarily enter" the ready-mixed concrete "business at any time" (App., *infra*, 27a). This is based solely on hindsight in 1960 and certainly could not have been known to petitioner's officers in 1945-1950 when they believed that "the probability or the likelihood of" petitioner "having to go into the ready-mixed concrete business was by far greater than the possibility that it might be able to stay out of it" (Vol. I, 75a-76a).

Undisputed testimony of the ablest *independent* witnesses in the country shows that petitioner's financial requirements to protect itself against the threat of the ready-mixed concrete industry materially exceeded its total assets during the entire 1945-1950 period (Vol. I, 92a-100a; Exs. 15, 16).

The hindsight rule is in direct conflict with the principles applied by the Second Circuit in *Casey* v. *Commissioner, supra.* In that case the Second Circuit explicitly stated that *"Congress did not want the taxing authorities to be second-guessing the responsible managers of corporations as to whether and to what extent profits should be distributed or retained"* and explained that the right to impose penalty surtax *"is not satisfied by proving that the corporation was mistaken as to its estimate of its future 'needs'."*

The vice of the erroneous hindsight principle on which the Court below has relied is that every precautionary measure honestly taken by a corporation against fire, hurricane, public liability, ruthless competition, or other hazards will be ruled out of consideration in determining reasonable business needs unless disaster occurs. This confronts corporations with the dilemma (a) of being destroyed by penalty surtax if they honestly take precautionary measures against hazards which do not occur or (b) of being destroyed by casualty if such protective measures are not taken and the hazards do occur. The hindsight rule, in conflict with all authorities, is unsound on reason and principle and constitutes an important question of Federal law which should be settled by this Court. See *Casey* v. *Commissioner, supra;*

Mertens, *Law of Federal Income Taxation*, Sections 39.42, 39.44.

The correct principle enunciated by the Second Circuit, based upon the corporation's honest belief during the period involved, should be uniformly applied and the seriously erroneous hindsight principle should be repudiated.

3. When the Tax Court's Own Specific Findings Are Taken Into Consideration and Added Up the Result Is, on the Tax Court's Own Basis, That Petitioner Had Accumulated Earnings Deficits of From $756,275.25 to $2,307,778.02 in 1945-1950. It Is Only on the Basis of Overlooking the Tax Court's Own Specific Findings as to Replacement Needs and Income Tax Liabilities That Any Different Result Could Be Reached. When the Documentary Proof and Undisputed Testimony, Not Rebutted in Any Manner, of Ten Eminently Qualified Witnesses Are Taken Into Account It Is Clear That Petitioner's Actual Accumulated Earnings Deficits in 1945-1950 Ranged From $11,276,341.66 to $17,207,940.39. In Direct Conflict With the Decisions of This Court and Other Courts of Appeals the Court Below Has Failed to Decide the Instant Case on the Basis of Either the Facts as Specifically Found by the Tax Court or the Undisputed Proof.

The findings of fact by the Tax Court Commissioner, which were adopted by the Tax Court, support petitioner's position (Vol. I, 1a-40a). When the reasonable business needs, *as found by the Tax Court*, are totaled the result is as follows (Vol. I, 19-28, 12a, 14a, 17a, 31a, 34a, 39a-40a):

	12/31/45	12/31/46	12/31/47
Reserves and Liabilities per books and records	$7,813,657.96	$8,365,270.33	$9,149,541.93
Total Assets	7,003,917.83	7,240,879.10	7,624,693.11
Surplus Deficit	($ 809.740.13)	($1,124.391.23)	($1.524.848.82)
Add:			
Loans to customers	72,917.00		135,000.00
Working capital	500,000.00	500,000.00	500,000.00
Accumulated Earnings Deficit	($1.382.657.13)	($1.624.391.23)	($2.159.848.82)

	12/31/48	12/31/49	12/31/50
Reserves and Liabilities per books and records	$9,516,556.31	$8,183,781.86	$8,435,649.78
Total Assets	7,858,778.29	7,880,412.59	8,271,879.53
Surplus Deficit	($1.657,778.02)	($ 303.369.27)	($ 163.770.25)
Add:			
Loans to customers	150,000.00		92,505.00
Working capital	500,000.00	500,000.00	500,000.00
Accumulated Earnings Deficit	($2.307,778.02)	($ 803.369.27)	($ 756.275.25)

It is solely by ignoring the specifically found replacement needs based on low prewar cost and the specifically found income tax liabilities that either Court below could reach the clearly erroneous crucial holding that petitioner had accumulated earnings beyond the reasonable needs of its business. See Vol. I, 19-26; Vol. III, Petition for Rehearing, pp. 1-8, 14-21.

Respondent failed to call any witness to testify on the merits in this case or to state that petitioner had accumulated earnings beyond the reasonable needs of its business. On the basis of documentary proof and unimpeached testimony of ten witnesses the result is that petitioner's total assets compared with its conclusively established reasonable needs as follows:

Year	Total Assets	Proven Reasonable Needs	Accumulated Earnings Deficits
1945	$7,003,917.83	$18,280,259.49	($11,276,341.66)
1946	7,240,879.10	20,422,503.59	(13,181,624.49)
1947	7,624,693.11	23,347,239.63	(15,722,546.52)
1948	7,858,778.29	25,066,718.68	(17,207,940.39)
1949	7,880,412.59	24,203,644.03	(16,323,231.44)
1950	8,271,879.53	25,291,480.04	(17,019,600.51)

The Court of Appeals' failure to decide the instant case either on the basis of the amount of reasonable business needs found by the Tax Court, but then disregarded, or, on the basis of much larger reasonable business needs, conclusively established by undisputed proof, is in direct conflict with the decisions of this Court and of other Courts of Appeals. *Montana Ry. Co.* v. *Warren*, 137 U.S. 348, 34 L. Ed. 681; *New York Life Insurance Company* v. *Gamer*, 303 U.S. 161, 82 L. Ed. 726; *Henderson* v. *Richardson Co.*, 25 F. 2d 225 (CA 4); *Wilson* v. *Williams Hardware Co.*, 32 F. 2d 103 (CA 4); *Ariasi* v. *Orient Ins. Co.*, 50 F. 2d 548 (CA 9); *Austerberry* v. *United States*, 169 F. 2d 583 (CA 6); *Blackmer* v. *Commissioner*, 70 F. 2d 255, 13 AFTR 957 (CA 2); *Belridge Oil Co.* v. *Commissioner*, 85 F. 2d 762, 18 AFTR 512 (CA 9); *Nichols* v. *Commissioner*, 44 F. 2d 157, 9 AFTR 285 (CA 3); *J. H. Robinson Truck Lines, Inc.* v. *Commissioner*, 183 F. 2d 734, 39 AFTR 788 (CA 5); *Boggs & Buhl* v. *Commissioner*, 34 F. 2d 859, 8 AFTR 9631 (CA 3); *Loesch & Green Const. Co.* v. *Commissioner*, 211 F. 2d 210, 45 AFTR 458 (CA 6).

The "*tendency of the Tax Court to ignore plain, uncontroverted testimony, and to reach for facts contrary to the testimony without there being any basis in fact for so doing*" was expressly pointed out

by the Sixth Circuit in the recent case of *Tank* v. *Commissioner*, 270 F. 2d 477, 486, 4 AFTR 2d 5495, 5504 (1959). Also, in the recent case of *Gordon* v. *Commissioner*, 268 F. 2d 105, 107, 4 AFTR 2d 5044, 5046 (1959), the Third Circuit found it necessary to reverse the Tax Court because *"the Tax Court arbitrarily disregarded unchallenged, competent and relevant evidence in the record which was inherently credible"*. The errors are far more glaring in the instant case than those judicially recognized in *Tank* v. *Commissioner*, *supra*, and *Gordon* v. *Commissioner*, *supra*.

The manifest failure to decide this case on the basis of either the findings of fact or undisputed proof, in direct conflict with the decisions of this Court and other Courts of Appeals, particularly invites consideration by the Supreme Court.

4. Under the August 11, 1955 Amendment to Section 534 of the Internal Revenue Code of 1954, Petitioner Was Entitled to Have Its Case (a) Considered on the Merits by the Secretary of the Treasury or His Delegate and (b) Tried and Decided by the Tax Court With the Burden of Proof on Respondent. Nevertheless, in Direct Violation of Section 534, as Amended, on the Basis of "Assuming" That Such Important Substantive and Procedural Rights Would Have Been of No Avail to Petitioner, the Court of Appeals Affirmed Despite the Fact That Petitioner Had Been Deprived of Consideration on the Merits by the Secretary or His Delegate and of Trial and Decision by the Tax Court With the Burden of Proof on Respondent.

Under the August 11, 1955 amendment to Section 534 of the Internal Revenue Code of 1954, petitioner was clearly entitled to have its case considered on the merits by the Secretary of the Treasury or his delegate and, if the decision on the merits was unfavorable, petitioner was entitled to have its case tried

in 1958 and decided by the Tax Court with the burden of proof on respondent. See 1954 I.R.C. Sections 534 (b), (c) and (e); Regulations (T.D. 6377, filed 5-12-59) Section 1.534-4; and Senate Finance Committee Report printed in the Appendix, *infra*, at pages 44a-48a. See also *Casey* v. *Commissioner*, *supra*; Mertens, *Law of Federal Income Taxation*, Section 39.30; Vol. I, 41-48; Vol. II, 12-16; and Vol. III, Petition for Rehearing, pp. 21-25. Despite the fact that petitioner was deprived of both of these important statutory rights, the Court of Appeals has affirmed the Tax Court on the "assumption" that such rights would not have benefited petitioner (App., *infra*, p. 37a).

The importance of the August 11, 1955 amendment was clearly stated by the Second Circuit in *Casey* v. *Commissioner*, *supra*, as follows:

> "Prior to the enactment of certain statutes which we will now advert to, a determination by the Commissioner of Internal Revenue that a corporation had allowed its earnings or profits to accumulate beyond the reasonable needs of the business would have carried a presumption of its own correctness, and the taxpayer would have had the burden of rebutting that presumption. Section 534 of the Internal Revenue Code of 1954, in its paragraphs (a)(2) and (c), provides that in circumstances present in the instant case the Commissioner should have the burden of proving the fact of the asserted unreasonable accumulation. And by the Act of August 11, 1955, c. 805, 69 Stat. 689, 690, section 4, the above provision of the 1954 Code was amended to make it *retroactive and applicable 'in the case of proceedings tried on the merits after the date of the enactment of this paragraph.'* The 1955 amendment is applicable to the instant case.

"The Commissioner of Internal Revenue then had the burden of proof that Bankers had unreasonable accumulated profits. *We think that the 1954 and 1955 enactments indicate that Congress did not want the taxing authorities to be second-guessing the responsible mgnagers of corporations as to whether and to what extent profits should be distributed or retained, unless the taxing authorities were in a position to prove that their position was correct. This recent expression of Congress should, perhaps, have some bearing upon our approach to our review of the Tax Court's decision.*

* * * * *

"* * * I believe that the statute meant to set up as a test of 'reasonable needs,' only the corporation's honest belief that the existing accumulation was no greater than was reasonably necessary. Section 532(a) was a penal statute, designed to defeat any plan to evade the shareholders' taxes, and there can be *no doubt that it presupposes some deliberate purpose to do so and is not satisfied by proving that the corporation was mistaken in its estimate of its future 'needs.'*" (Emphasis supplied)

The wholly unfair treatment to which petitioner has been subjected is unmistakable: Respondent, by his omission in not sending the requisite notification, deprived petitioner of its right to review by the Secretary or his delegate and the burden of proof clearly should have been upon respondent. Nevertheless, by the Tax Court's error, petitioner has been deprived of trial and decision with the burden of proof on respondent and, instead, has been subjected to the disadvantage of trial and decision with the burden of proof on petitioner (Vol. I, 44-47; Vol. II, 12-16; Vol. III, Petition for Rehearing, pp. 21-25).

By contrast, the Second Circuit's eminently fair and proper treatment accorded the taxpayer, pursuant to provisions of the August 11, 1955 amendment, in *Casey* v. *Commissioner, supra,* emphatically illustrates the inexcusably unfair treatment to which petitioner has been subjected below in violation of its clear and important legal rights. The direct conflict between the two Courts of Appeals involves basic statutory rights of the greatest importance to taxpayers.

On this record, there is no basis for assuming that the Secretary or his delegate would have decided against petitioner or that the majority of the Tax Court would have decided against petitioner had the burden of proof been properly placed upon respondent for trial and decision below. Thus, it is clear that petitioner's rights, both substantive and procedural, have been violated to its serious detriment and that such important rights cannot properly be "assumed" away.

The statutory right to review by the Secretary or his delegate was of vital importance to petitioner because the record clearly shows (a) that its case was never considered on the merits by the Secretary or his delegate, (b) that actually the deficiency notices were sent to petitioner without any investigation or knowledge on respondent's part as to the reasonable needs of the business, and (c) that deficiency notices were sent without even being read by any official authorized to determine deficiencies (R. 412-453, 787-831, 1129-1151). The statutory right to trial with the burden of proof on respondent was equally important to petitioner.

It is respectfully submitted that petitioner's important statutory rights, *specifically provided by*

Section 534, as amended, entitling it to review on the merits by the Secretary or his delegate and to trial and decision with respondent having the burden of proof, cannot properly be denied by the Court of Appeals' "assumption" as to (a) what the result might have been had petitioner been granted the review on the merits to which it was entitled or (b) what the decision of the full Tax Court would have been had the case been tried and decided with the burden of proof on respondent.

Petitioner respectfully maintains that the Tax Court and the Court of Appeals are without authority to ignore the clear and important statutory rights expressly granted to petitioner by Congress in the August 11, 1955 amendment to Section 534 of the Internal Revenue Code of 1954. See Section 534, as amended, the respondent's own Regulations, and the pertinent Senate Finance Committee Report set forth in the Appendix, *infra,* at pages 44a-48a. The Court of Appeals' "assumption" that had those basic rights been granted they would have been of no avail to petitioner is in direct violation of Section 534, as amended, and in violation of due process of law. In this case such an assumption is neither legally nor factually warranted and, in any event, the deprival of such important statutory rights, specifically granted by Congress, on the basis of assumption involves an important question of Federal law that should be considered by this Court.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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